NGFS
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Central banks and supervisors taking action on climate change

Introductory remarks by François Villeroy de Galhau,
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Risque Climatique – *Call to Action*

Ladies and Gentlemen,

It is a great pleasure for me to welcome you to the Banque de France's premises to kick off this public session of the NGFS conference. We have been waiting for this moment for a while, and here we are. The NGFS is releasing today its first comprehensive report, entitled "A call for action", including its six recommendations.

Thomas Paine, an English-born political philosopher and citizen of the world, said in *The American Crisis* (circa 1776): "If there must be trouble, let it be in my day, that my child may have peace." Climate change is real, it is global and irreversible. Even if policymakers bear the primary responsibility, we need all hands on deck to tackle climate change, as demonstrated today with this wide audience. Indeed, "preventing the airplane from crashing" remains a continuous endeavour, which is now undertaken by many more institutions every day.

In mainstreaming sustainable finance, finance cannot replace policymakers but finance can help. And as a central banker and supervisor, the Banque de France is determined to help. Last year, in Amsterdam, I even said that this challenge is our "new frontier". This is why we initiated the Network of central banks and supervisors for Greening the Financial System (NGFS), during the One Planet Summit on December 2017. And, in 16 months, our club of the willing has increased almost fivefold, from 8 founding members to over 40 members and observers with its Chair Frank Elderson and the Banque de France as Secretariat. We are now represented on the five continents; NGFS members' jurisdictions cover 44% of global GDP and 45% of greenhouse gas emissions. We collectively supervise two-thirds of systemic financial institutions, banks and insurers alike. What appears obvious to most of us today was not previously set in stone.

With our global effort to ensure that the Paris Agreement produces results, the NGFS' first "A call for action" report has the potential to lever the financial system and I hope that it will pave the way for a "paradigm shift" in the wider community of central bankers.

In my remarks today, I will (i) take stock of central bankers and supervisors' achievements towards tackling climate change, which are significant and (ii) discuss four important tasks that still lie ahead.

I. Central banks and supervisors are promptly moving ahead regarding the snapshot of risks

In its first progress report, released in Bali in October 2018, the NGFS unanimously concluded that "*climate-related risks are a source of financial risks. It is therefore within the mandates of Central Banks and Supervisors to ensure the financial system is resilient to these risks*." So what do we do?

a. Integrating climate-related risks into micro-supervision

This is an ambitious but complex task, on which progress has been made in many countries. Looking at the potential courses of action for supervisors, I believe that our main priority should be the disclosure of existing exposures in the financial sector, what I usually call "the snapshot of risks". A number of supervisors have paved the way, including the DNB, the Bank of England/PRA and the French supervisory authority (ACPR). The ACPR published last week a second report on the exposures of French banks and insurers to climate risks. This report gives a clearer view on climate risks and opportunities: asset exposures of financial firms to physical risks remains non-material in France thanks to investments in very low risk zones; banks' exposures to transition-related risks were slightly reduced between 2015 and 2017 and now represent roughly 12% of credit risk's exposures at default. Our supervisor also has a clearer view on the blind spots in the risk management framework, which must be addressed: executive bodies are committed to embracing further climate risks at the highest level of decision-making but the degree of implication across the French financial sector is still heterogeneous; the granularity of the analysis provided by banks and insurance companies is not sufficient.

This step should be widely promoted among NGFS members, who, I believe, need to leverage best practices throughout its membership. I therefore very much welcome the supervisory handbook that will be prepared as a NGFS technical deliverable for 2019-20.

b. Integrating sustainability factors into own-portfolio management

Central banks must send the right signal and lead by example in their investment and disclosure policies. The DNB has signed up to the UN Principles for Responsible Investment. Norges Bank, which manages the Norwegian sovereign wealth fund, has advocated a diversification of the portfolio and is implementing a divestment strategy dedicated to selling off some oil and gas stocks. We, at the Banque de France, adopted in March last year a Charter on Responsible Investment for the management of our own funds and our pension portfolios: this means allocating them to socially and environmentally responsible investment funds. With respect to disclosure, in March 2019 we were the first central bank to publish our climate-related risks' exposures. We are also working to further align our reporting with a TCFD-like approach that would fit the specificities of central banks. We trust our experience will be useful to the NGFS membership in defining some best practices as far ESG investment for central banks is concerned.

We can be proud of what we have achieved in 16 months, but it is "time to roll up our sleeves": the merciless perspective of a more than 2°C world requires us to strive to do better and to do it now. Developing practical solutions now tops the agenda of the NGFS "Season 2".

II. <u>The road ahead for central banks/supervisors and other players too</u>

a. Disclosures and taxonomies, two faces of the same coin

We are currently facing a chicken and egg dilemma. In order to bridge the data gaps, we must rely on enhanced disclosures that need to be built on sound taxonomies. But we need some data to set out a proper taxonomy!

It is time to follow the path set by the TCFD on one side and the European Commission on the other to address all issues at the same time. It means working jointly on disclosures and taxonomies. It will notably help to enhance the quality of disclosure and, ultimately, its relevance in internalising the current climate change externality for all firms.

We will then be in a position to move gradually towards compulsory transparency based on a "comply or explain" principle, such as that of Article 173 of the French Energy Transition Law that could usefully serve as a reference.

b. Integrating climate-related risks into financial stability monitoring

Substantial work remains to be done to achieve "the video of risks". Our feeling is that risk premia do not currently appropriately reflect climate risks. And therefore I believe that we, as central banks and supervisors, must push for a forward looking vision of the impacts of climate risks. In order to properly size the financial effects of climate change, our goal is clear: we should be able to design some comprehensive climate stress tests.

What does it mean in practice? The snapshot of risks provides information on exposures. But achieving a forward looking scenario analysis implies bringing together three "bricks":

- A handful of severe enough but realistic transition path scenarios all the way to 2050. The NGFS is working on those and plan to publish some technical papers soon.
- Macroeconomic assumptions to capture the impact of climate change on macroeconomic variables (productivity, inflation, unemployment, etc.)
- The direct and indirect exposures of the financial system to climate risks. Here of course, disclosure can help.

We are not there yet, climate risk analysis needs to rely on new methodological tools in order to deal with challenges related to long-run impacts, accounting for technological change and shifts in political priorities and social behaviour for instance, non-homogeneity and non-linearity of impacts, and irreversibility of effects. We need to look beyond the standard one-year horizon for default probabilities that does not fit the climate agenda.

c. The green economy is still in its infancy and needs to mature

As time goes by and our ability to achieve a 1.5 to 2°C scenario is seriously challenged, the amount needed to finance the transition is increasing steadily. The demand for green assets is high, but the supply of green assets fails to keep up. This quantitative challenge to match demand is linked to the massive investment required to promote further development of technologies and to accompany shifts in social behaviour. The amounts at stake vary, but as an illustration, the last Intergovernmental Panel on Climate Change (IPCC) report, published last October, estimates that until 2050, the energy-related mitigation investments to limit warming to 1.5°C amount to USD 900 billion per year whereas climate-aligned bonds issued in 2018 reached USD 149 billion. Green financing requires an innovation-friendly framework: green loans, green securitisation, green covered bonds, green derivatives, green crowdfunding platforms and green private equity should all be promoted, keeping in sight our heading, which is preserving financial stability. The work of the Technical Expert Group on Sustainable Finance of the European Commission on green bond labels and sustainable benchmarks should be well understood as a game changer by the financial system: green finance should definitely mature, upgrade its professional standards and be "greenwashing proof".

Green finance has actually the ability to be a powerful transformational force but there will be no transition to a low-carbon future without further engagement from corporates, from large companies to SMEs. Financial institutions can provide a trickle-down effect, thanks to comprehensive CO_2 disclosures or divestment strategies. But the real economy must embrace the transition on its own. Once again, appropriate public policies, like a credible carbon price, will set the proper incentives.

d. Further developing the climate agenda in an inclusive manner

Climate change will trigger strong distributive effects: agriculture in Sweden might benefit from an increase in global mean surface temperature while 145 million people in China are threatened by sea rise in a +4°C scenario. There will be winners and losers internationally but also within countries.

This calls for a deeper international cooperation which will promote a globally fair transition to a low-carbon economy. And each and every one of us – civil society; States and regional regulators; academics, NGO's and think-tanks; corporates and financial institutions; central banks, supervisors and standard setters – has a part to play: it is a shared challenge that no one can tackle alone.

We should also focus our efforts and attention on emerging countries and developing economies. They are usually hit harder by climate risks and on top of that also face environmental risks at large, (such as air pollution, water pollution and scarcity of fresh water, land contamination, harming biodiversity and deforestation). In 2017 alone, almost 5 million people worldwide died due to air pollution. Even if environmental degradation and associated (financial) risks are often more local in their reach, there are nevertheless compelling reasons for the NGFS to look at environmental risks relevant to the financial system and differentiate more in the recommendations provided between the types of financial systems.

Conclusion:

The success of the Paris Agreement will depend on our ability to move forward in an inclusive manner. The world is in the hands of all of us. But certainly some have a greater influence on its fate than others. Central banks and supervisors, within the NGFS and alongside men and women of good will, are playing their part in mitigating the disruption caused by climate change. If we want our children to have peace, I am calling on all of you to act too.